House of Commons
Treasury Committee

Appointment of Andrew Bailey as Deputy Governor of the Bank of England

Oral and written evidence

Wednesday 13 March 2013

Andrew Bailey, Deputy Governor, Prudential Regulation, Bank of England

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Oral evidence

Taken before the Treasury Committee

on Wednesday 13 March 2013

Members present:

Mr Andrew Tyrie (Chair)

Mark Garnier
Stewart Hosie
Andrea Leadsom
Mr Andy Love
Mr Pat McFadden
Jesse Norman
Teresa Pearce

Examination of Witness

Witness: **Andrew Bailey**, Deputy Governor, Prudential Regulation, Bank of England, gave evidence.

Q1 Chair: Thank you for coming to give evidence to us this afternoon, Mr Bailey. You are pretty new to insurance regulation. Do you know how to do the job?

Andrew Bailey: I am very new to insurance regulation; that is true. As you know, the Bank of England does not have a background in insurance regulation. Over the last two years, since I moved to the FSA, I have been immersing myself as best I can in insurance regulation, which is very interesting. We have obviously an inherited stock of insurance supervisors. As you may know, we want to raise the level of experience of our supervisors. It is fair to say, and it is a point the industry makes to me, that, for reasons I am not entirely clear about, we—interestingly—have the lowest level of experience in insurance, lower than the banks. So that is a clear task, but we have some good senior staff. We have increased our engagement with boards and senior management, as we have with banks. I have seen the chairmen and the chief executives quite often and we are getting to grips with what I think are some of the quite big issues the industry faces. Solvency II tends always to dominate any discussion we have with the insurance industry.

One of the things you realise when you start dealing with the insurance industry is that it is not one industry. There is a Life industry and a General industry and a few of the firms cross over, and then within the General industry there is also the Lloyd's market. However, one of the interesting issues that does cross over—it affects the two parts in slightly different ways—is the impact of sustained low interest rates, which is quite marked because of the nature of the industry, the long-term contracts they write, and the guarantees built into those contracts and the pricing of liabilities.

Interestingly, one of the advantages of having insurance regulation inside the Bank of England is that we have already seen a better understanding between the monetary policy side of the Bank of England and the insurance supervisors about some of the common issues they face and the transmission of monetary policy through the insurance industry. So that is quite encouraging.

Q2 Chair: Do you think it was luck or judgment that kept our insurance industry out of the financial crisis?

Andrew Bailey: I am not sure. My impression is it has been a bit differential. There are one or two areas and one or two companies that got themselves highly leveraged in the run-up to the financial crisis. That is not a function of the fact that they were insurance companies, but of falling into the same sort of process as quite a lot of non-financial companies. There is nothing secret about this. Some quite well-publicised debt restructuring has had to go on.

For the mainstream insurers, I am not sure whether it is pure luck or pure judgment. They were somewhat distant from it. Of course, some of them had had a worse scare 10 to 12 years ago in the bursting of the dotcom bubble. We had also had the Equitable effect. That has been in the Life sector. They have had some experiences in that period when the banks were not having experiences.

Q3 Chair: Fortunately we had had a couple of medium-sized crises that had purged them of complacency?

Andrew Bailey: Yes. Interestingly, it did cause the FSA to introduce a new framework of insurance supervision in that period, the so-called ICAS framework, which is the one there today and we are modifying in the context of the delay to Solvency II. You can point to the fact that some actions were taken in the wake of those two experiences that were certainly beneficial.

Q4 Stewart Hosie: I want to stay on insurance because it is important and particularly Solvency II because it is fiendishly complicated. It seems to be taking forever to get any kind of certainty at the end, but you have said that the costs of Solvency II on insurance companies are indefensible. Why are the costs so high and what makes them indefensible?

Andrew Bailey: Solvency II has been going on now in various states for not far off 10 years, I think, as a process that is grinding through the European process. As I said in the points that I submitted to you, in all honesty, we do not know today when and in what form it will be completed. This is more of an issue for the Life sector than the General sector. There are no big outstanding issues for the General insurance industry, but for the Life insurance industry there are because there are some very highly charged issues in

the European debates where, frankly, quite big national interests are at stake in that sector and those are nowhere near settled and are going nowhere at the moment.

Q5 Stewart Hosie: In terms of the European debate, clearly, if there is a massive delay or further delays or uncertainty with Solvency II, how will that affect the three-pillared approach Europe has taken if the insurance bit is not fixed? Does that add extra risk to the management of financial risk generally?
Andrew Bailey: It is. It obviously depends on how what I might call "systemic" you think the insurance industry is. What you have, therefore, is different national insurance industries at very different points in terms of the regulatory framework that they operate under, but bear in mind, of course, that that is not unusual. If you go to the US, it is still state-level insurance regulation. It is a very different industry from banking.
Are there risks? There are risks in the sense that you have quite different approaches and standards of insurance supervision. You have cross-border activities. Just finishing off your first question, I said it is indefensible because the industry was encouraged, kind of pushed, to start off on a very detailed approach to preparation for Solvency II. For reasons that it is possible to explain, more of the UK industry has gone down the models route than the standardised route. The reason for that is not particularly out of a love of models. It is because the standardised route does not fit two important areas of the industry that the UK has a relatively large component of: one is the Lloyd's market and the second is the annuities and with-profits areas. The consequence is that more UK insurers are going down the models route than happens in other countries. The way in which Solvency II has been set up has snowballed the costs.
We got to last summer with the clear sense that Solvency II was going nowhere in terms of completion. There was incremental creep, whereby every six months it was clear that it was not going to be implemented for another six months, and so it got rolled out six months, and everyone went on preparing as if something had happened when, in fact, nothing had happened. The costs of doing that are very substantial. I was staggered when I got to the FSA to find the FSA themselves had budgeted between £100 million and £150 million to implement Solvency II. Whether I should be staggered or not is a matter of judgment. I could tell you the Bank of England has never spent anything like that amount of money on anything.

Q6 Stewart Hosie: I am glad I asked that. We may come back to the specific costs another time because that is extraordinary.
Chair: Except QE.
Andrew Bailey: Except QE. That is slightly different.
Stewart Hosie: In terms of what you said about the snowballing costs and the constant delays, there is the impact on policyholders in terms of costs of insurance.
Andrew Bailey: Yes.
Stewart Hosie: Can you measure that?
Andrew Bailey: You have to add up, particularly, obviously, the costs in the industry because the FSA's costs, while they look big as a number—and, indeed, they are big as a number—they are quite small relative to the costs of the industry. People in the industry will tell you they think it is several billion pounds. If you talk to the Chief Executive of Legal & General, he says it is twice the cost of Crossrail. I have not gone out and tried to prove that, but that is what he says.
Chair: We do not know the cost of that yet.
Andrew Bailey: It has taken longer.

Q7 Stewart Hosie: People in the industry are suggesting that there might be an internal bill passed on to policyholders approaching £40 billion, if it is twice the cost of Crossrail?
Andrew Bailey: You have a higher cost for Crossrail than he does. It is several billion pounds, put it that way.

Q8 Stewart Hosie: One final question then. How much of your time do you intend to spend on insurance given what you have just said in your opening questions?
Andrew Bailey: I am very clear, and we have been very clear with the insurance industry, that we are, of course, very aware, going back to the point the Chairman mentioned, that they thought they were second-class citizens in the Bank of England's pecking order. Of course, the other problem with that is that the banks, for well known reasons, take up and have taken up a very large proportion of the regulators' time. We have gone out of our way—and I have gone out of my way to say—they are not second-class citizens. I say to them quite honestly that when the Bank of England is asked to do something, we do it seriously. We have done that. The feedback I get is that they understand that, and they have seen the evidence that we are paying a lot more attention to them.
What we did on Solvency II, in this particular case, was last autumn, I said to the chief executives, "Look, we are very clear this is not settled. We think it is not going to be implemented until at least 2016. Therefore, we are going to stop this incremental approach, whereby you just spend the same amount of money per day for longer, which is just racking up costs, and re-plan it". We have scaled the costs back. In the next year, because the FSA imposes a special levy on the industry to fund its Solvency II costs, the additional special levy will be only about £100,000, whereas last year it was getting on for about £20 million. We saved about half of that special levy last year to fund future costs. That £100 million to £150 million that I mentioned, I am hoping to get back to somewhere around £80 million. Bear in mind that something around £60 million has already been spent, so I cannot do much about that. We agreed what we call the "ICAS plus" regime with them, which was to say, "Let us take the useful bits of Solvency II that you have already prepared and bring them into our current regime and produce a sensible interim regime", and that has been a good outcome with the industry that we are now taking forward.

We are giving them attention. I keep saying to them, "If I could spend less time on the banks and more time with insurers, that would be good news all round".
Stewart Hosie: Thank you.

Q9 Andrea Leadsom: Good afternoon, Mr Bailey. Do you think that the financial sector is too reliant on credit ratings still?
Andrew Bailey: Some of the bolder statements that happened at the height of the crisis and immediately afterwards that we were going to get rid of the credit rating agencies have not been realised, and I think those were frankly rather optimistic.
I am very clear that some of the worst practices in terms of credit ratings and their use were what I call business models in banks that, in effect, hardwired credit ratings into their whole structure. The classic example is Northern Rock. Northern Rock was using the so-called originate-and-distribute model. It had a balance sheet, when it failed, of about £110 billion of which £60 billion was securitisation and covered bonds. The effect of that was that you had this big animal out there that had to be fed mortgages, so they had to keep generating mortgages.
The interesting fact is that Northern Rock had about an 8% or 9% share of the stock of UK mortgages, but when it failed, in the six months previous to that, it had 20% share of net mortgage because it had to keep doing volume. The problem was you had hard-rating triggers in there under securitisation vehicles. One of the things that became very apparent, certainly when I got involved in it from a resolution point of view, was that the cash that was coming out of the securitisation vehicles by virtue of people paying their mortgages, basically, was being re-deposited into the bank. This £50 billion legacy bank had about £7 billion or £8 billion of cash that was coming out of the securitisation vehicles, but the problem was that there was a hard-rating trigger on them. The minute they got their rating downgraded, that cash could go out of the door. At that point, the whole thing just comes down like a pack of cards and that is the sort of hard-rating trigger we are determined to get rid of.

Q10 Andrea Leadsom: Will you be requiring financial institutions to do their own analysis, for example, of complex financial transactions rather than relying on credit rating agencies?
Andrew Bailey: Yes. They should have the capacity to do internal analysis. Whether they decide also to use external sources as a check and an input to that, I am not so fussed about, but an institution that has no capacity to assess risk and depends on an outside party—again, you are hardwiring a dependence in there.

Q11 Andrea Leadsom: Do you think that Britain's loss of the AAA status has had an impact on Britain's ability to borrow and do you think it matters what the credit ratings agencies think?
Andrew Bailey: Interestingly, if you look at the evidence so far in terms of financial markets, you would conclude that it has not had much of an impact. Now, there may be all sorts of reasons for that. Of course, the key thing there will be to what extent financial markets were expecting that to happen, so the news content of the actual announcement was not so great. It may also be that two of the three main rating agencies still have the UK rated AAA and, insofar as people are looking at the two out of three, then it has not had the full impact, in which case you can say there will be more shoes to drop. It may also be state contingent, in the sense that the impact depends on what the state of the world is when you make that announcement, but I think you would have to conclude so far that the impact on financial markets has not been very great.

Q12 Andrea Leadsom: Does that suggest that the power of credit ratings agencies is not as strong as it used to be?
Andrew Bailey: I think probably to a degree it does. I have certainly heard people in the markets say that they use a range of indicators, and that using that range of indicators in the case of the UK sovereign credit rating has mitigated that impact. The other point, of course, is that Moody's downgraded but then put the rating on stable; so in a sense they did not cast a future uncertainty, which they have done in some other cases.

Q13 Andrea Leadsom: Yes. Just to change the subject slightly, do you think that the new EU-proposed restrictions on bonuses will be good or bad for the industry and, specifically, do you think that there is a risk that, since, as we know, bonuses tend to fall when banks perform worse, it is likely that banks will be under pressure to pay higher salaries and, therefore, be unable to reduce their costs when their performance worsens?
Andrew Bailey: I could just simply say "yes". I am very concerned about it. What we have managed to do over the last two or three years is bring a number of disciplines into the remuneration structure. I do have to preface this with the point I made to the Parliamentary Commission last week that, of course, it is an odd world where you promise bankers egregiously large amounts of money so that you can threaten to take it away from them and somehow thereby incentivise them. What has happened is that less cash is going out of the door, so more remuneration is in the form of equity. There is much more deferral and there is real application of what in the lingo is called "malus", i.e. when an event happens, as has happened in the past, that crystallises a cost, then for the unvested deferred part of remuneration that can, in fact, be cancelled.
I was adding up an interesting statistic. If you take the major UK banks this year and you add up the reduction in bonus pools as a result of reducing those to reflect the cost of things like LIBOR and so on, and the malus element, which is again the reduction of unvested deferred remuneration, the sum of those two things this year comes to £2.5 billion, which is not a small number.
Andrea Leadsom: No.
Andrew Bailey: I say that because if the EU directive has, firstly, the effect of increasing fixed remuneration as fixed a way to get out of the ratio bind, that is cash out of the door to start with. Secondly, of course,

remuneration is not deferred; so it reduces the power to use that incentivising mechanism. That is a concern, quite frankly, in the sense that it will reduce the discipline in the structure, but it will not obviously have the effect of reducing overall remuneration because the concern is that that employed will push up fixed remuneration for the code staff.
Again, I did a back-of-the-envelope calculation for the major UK banks and said, "What if, for the code staff"—I think there are about 1,300 code staff in the major UK banks—"on average you re-set the ratio to 1:2, so you assume the shareholders approve it, that is an increase in fixed remuneration of around £500 million a year".

Q14 Andrea Leadsom: Gosh. Do you think, if it is imposed, it could have a detrimental effect on the future location of senior bankers? In other words, could it drive business away from London and the rest of the EU?
Andrew Bailey: Yes, it is possible. Of course, it will also institute an unhelpful culture of banks spending their time finding ways around the rules—
Andrea Leadsom: Yes.
Andrew Bailey:—with some sort of, in the loosest sense of the word, sanction because we all think it is a bad thing, and that is not a good place to be either. When you had the people from UBS before you, they put up a pretty bad performance and did not give the impression they were managing the institution. One of the things we have done across the board with the major foreign banks operating in the UK—I know the point was made in the hearings of the Parliamentary Commission—is say, "If you are running a large operation in London, it has to be run by somebody who is in the senior management of your institution globally. It is not being run by a country manager, who may get around London a lot, but is not in the risk management framework of the institution". We have been pretty successful in this. My worry is that these people will suddenly say, "I am in New York from now on. I am still, in some sense, running the business in London, but I am running it from New York". From a risk management and control point of view, that is not a good place to be.

Q15 Andrea Leadsom: My very final, very short question is do you therefore think that this has been driven by some desire for retribution rather than common sense in how to reform the financial services sector?
Andrew Bailey: I can understand it. I think it has been driven by popular anti-banker sentiment. A lot of people are saying that the UK Government failed in this sense. I do not think the UK Government failed. I think, given what they were facing, any Government was finding it very difficult to go along and say, "It is not sensible to do this", and by making that argument appearing to defend bankers' remuneration.

Q16 Chair: What you are saying is public pressure has inadvertently put us in a worse place than we were before we started?
Andrew Bailey: I think that is right.

Q17 Jesse Norman: Mr Bailey, you previously worked for Eddie George when he was Governor of the Bank of England.
Andrew Bailey: I did.

Q18 Jesse Norman: You have said in your Q&A that you were able to see the structural and other failings of the tripartite system. Could you dilate in detail on that?
Andrew Bailey: I was present with Eddie George when he was told that the FSA was being created. I was his private secretary at the time, in 1997. This is all well documented. It was not a good moment. I think the reason that is significant for me is that it got the tripartite system off on a very bad footing, because, in essence, you then had a state of conflict going on at the point when the foundations of the tripartite system were being laid down. The famous tripartite MoU was constructed in very difficult circumstances when relations were very difficult and the FSA did not exist.
What is the long-run consequence of that? The responsibilities were not very well defined because it had something of the characteristic of a peace treaty between parties that are not really at peace. What then happened was that there was a very long period of peace because nothing happened in the financial system for about 10 years—no event of any significance. I think that some of the structural failings that got built in early never got tested, so never really got found out until things got very bad. I hold to that.

Q19 Jesse Norman: How do you write a MoU when one party feels completely betrayed and one of the other parties does not exist?
Andrew Bailey: The approach that was taken, certainly by Eddie George, was quite defensive. He felt that he had been put in a very difficult position. By the way, this was not about the substance. It was about the process. I can tell you that he always took the view about banking supervision being in the Bank of England and, bear in mind, as you will remember, this was not a glorious history of banking supervision in the Bank of England before 1997. I will say to people, "We are not going back to those days", because those of us who were involved and remember it remember that the bank was pilloried for BCCI and Barings and so on. However, he always took the view that he could argue both sides of, "Should it be in the Bank or should it not" with almost equal force and he probably preferred it to be in the Bank because he did not want to shake the Bank up. Although, it was not the substance; it was the process that was very difficult.

Q20 Jesse Norman: Do you think the new structure is also flawed?
Andrew Bailey: First, the Twin Peaks system is a clear improvement on integrated regulation. It has been very interesting for me because I spent two years in the FSA. I had worked very closely with the FSA as Head of Resolution before that, but from the perspective of being an outsider looking in. The thing that struck me in the first year I was in the FSA, which was basically up to a year ago—and a year ago, we

did the internal split—but the first year when I was responsible for integrated regulation of banks, was how difficult it was and obviously had been, looking at the history, to balance conduct and prudential when they were being done together. My assessment of it was that the FSA had never managed to balance the two in a stable equilibrium. One had always been on top of the other but it was not the same way round. Before the crisis, I think it is pretty clear that conduct took precedence over prudential. Clearly once the crisis happened, the machine switched around, but what you get from that was it was not a stable balance. The other thing that became very apparent was that it was very difficult for senior management to balance the competing demands on their time when you have conduct and prudential. There is an interesting test of this. You will be familiar with something called Key Data. If you go into the Bank of England, they do not deal with Key Data because it is a consumer issue. It is a conduct of business issue. It is a very bad conduct of business issue, but it is clearly a conduct issue. If you are in the FSA, you are trying to balance dealing with that against dealing with failing banks and I think that was very hard for them to do in the end.
Twin Peaks, for me, helps. We have seen in the last year a much stronger articulation of what I call prudential and conduct arguments where they butt up against each other, but Martin Wheatley and I are also very clear that it is not good enough just to have elegant arguments about issues in which points are put better, you have to resolve things. We have to prove we can do that.

Q21 Jesse Norman: Let us talk for a second about the culture of the FSA. Could you describe that candidly as was and as it is now?
Chair: Is it the word "candid" that is causing the pause?
Andrew Bailey: Actually two things. It is quite hard to define the culture of the FSA today because it has gone two different ways. It is legally still the FSA and obviously functions in that sense but for the last year, it is quite interesting, as we split it, that the supervisors went quite clearly to their different points. What struck me overall about the approach, particularly the approach to prudential supervision in the FSA, was that they had clearly changed it in the wake of the crisis. Whether they used the term "light touch" about themselves I do not know, but clearly that was the effect and it goes back to my point about prudential being subordinated to conduct. They moved to what they called intensive and intrusive supervision. The problem with intensive and intrusive is that there is no end to it. Unless you focus it, there is no end to it because how many drains do you want to rip up? That struck me as the problem. There was a lack of clear focus on what the objectives of supervision were. That is what we are correcting in the PRA and, by the way, that goes back to your first question, which is having very clear statutory objectives and very clear objectives underneath that, which I do not think the 1997 reforms achieved. It was this question of lack of clear focus and what the end objective was that struck me, certainly about prudential supervision, and that is what we are changing.

Q22 Jesse Norman: Spaghetti junctions, stove pipes, competing fiefdoms, lack of clear responsibility, under-lap, none of those things. I do not see you testifying against that.
Andrew Bailey: The lack of clarity certainly shows up in the shifting pattern of what is the focus of attention, which was this question about balancing conduct.
Jesse Norman: However, some of those words would not be inappropriate?
Andrew Bailey: Sorry?
Jesse Norman: Some of those words would not be inappropriate?
Andrew Bailey: No, not in that sense.

Q23 Jesse Norman: When the PRA comes into the bank it is going to have 1,000-odd people or increase the size of the bank by 50%?
Andrew Bailey: Yes.
Jesse Norman: I do not think there has been anything remotely in the bank's recent history that is a comparable change.
Andrew Bailey: No.

Q24 Jesse Norman: What are the issues that are going to arise for the Bank of England out of such a colossal act of absorption?
Andrew Bailey: It is interesting. It is the first time the Bank of England has expanded in anybody's working life in the Bank of England. It has always been a shrinking or static organisation because, over the years—I have been there nearly 28 years now—a number of functions have either come off or declined. It had getting on for about 5,000 staff when I joined and in the previous change it was down to about 1,700 or 1,800. We have obviously had to gear the machinery up to accommodate and adapt this, which, by the way, has mostly happened now. We are in our new building. We are technically in there obviously as the FSA. All staff are in the Moorgate building. They are being serviced largely by the Bank of England in terms of IT and what have you, so that has happened.
We are now working on what I might call the cultural integration because if we are going to make the system work from the point of view of the responsibilities of the Bank of England, which is the MPC macro-prudential and micro-prudential, they obviously have to work together. Interestingly, going back to the 1990s, this was not something that worked particularly effectively in the Bank of England in the days when it had larger responsibilities. This is not, as I say, going back to old territory. It is trying to make something work afresh, and I think we are making pretty good progress. I am always encouraged when we see a stronger bond between the financial stability and monetary policy sides of the Bank and the supervisors, which is beginning to happen, but we have a substantial way to go. Do not get me wrong.

Q25 Jesse Norman: Final question, could you comment on staff turnover and your ability to recruit? By staff turnover, I mean loss of good staff.
Andrew Bailey: Yes. The FSA has traditionally had higher staff turnover than the Bank of England, so as a rough metric it is probably double. With both organisations it is cyclical. It very much depends on the state of the outside market as to what the staff turnover rate is.
Jesse Norman: When you say roughly double, do you mean 15% to 20% a year?
Andrew Bailey: When I moved to the FSA two years ago, it was probably up in the higher teens and the Bank was probably around eight or something like that. Today both are lower, so probably the Bank is down to five and I think the FSA, certainly the prudential side, is probably down to about nine.
Obviously, that can be due to a number of reasons. The outside job market is obviously not good in the City at the moment, so that is the cyclical point. Obviously, we would like to think we are creating a better working environment and creating an environment where people want to work in a public policy institution for its own reasons. There is probably at least one reason why a supervisory authority will have a higher turnover, which is that one of the things you notice about supervisors is they have much more intensive contact with a small number of institutions.
Many of the Bank staff obviously meet people in the outside world, but they meet lots of people, whereas a supervisor, if you are supervising a major institution, you see them and, of course, the institutions know who the good ones are and who the less good ones are, and they do bid for them. That is fact of life, I am afraid. It has always been true and it is true in foreign supervisory institutions. I am pleased the rate of turnover has come down but the jury is out as to how successful we have been until we see where the cycle in the outside job market goes.

Q26 Jesse Norman: Are you able to grow or recruit attractively?
Andrew Bailey: Yes, we are. I think the Bank will be a big help here because the Bank has a very strong reputation in the recruitment market, particularly in the graduate recruitment market. I am optimistic that we are retaining good staff but, as I say, the jury is out as to how successful we are.
Jesse Norman: Thank you.

Q27 Teresa Pearce: Good afternoon. On the objectives of the PRA, one of them is to promote safety and soundness and not to make sure no firm fails but to make sure it does not have an impact on the wider economy. One of the threshold conditions for firms that come within this is that the firm's business be conducted in a prudent manner—
Andrew Bailey: Prudent manner, yes.
Teresa Pearce:—and the firm be fit and proper and appropriately staffed. You are meant to assess firms against that standard. How will you do that?
Chair: Andrew, before you answer that question, I notice the sun was in your eyes. We do not deliberately do that.
Teresa Pearce: No, keep it on.
Andrew Bailey: You might not get sensible answers.
Chair: If you want to move one seat down.
Andrew Bailey: Let me have a go.
Teresa Pearce: It would be better.
Mr Love: Unfortunately it is the only day we have had the sun.
Teresa Pearce: Now I will have to get my torch out. Is that better?
Andrew Bailey: Yes.
Teresa Pearce: Hello.
Andrew Bailey: Hello. The threshold condition obviously of the prudent manner is absolutely the core threshold condition because that is the prudential standard of capital and liquidity.
Teresa Pearce: Nevertheless, how will you monitor?
Andrew Bailey: We do this on a continuous basis because firms have to meet the threshold conditions every day. We do that through continuous monitoring of their capital positions, their liquidity positions and their large exposure positions to counterparties. However, the key thing that I would emphasise here about what is changing is that it is becoming what I call much more forward looking. This is the judgmental element of supervision.
You can obviously do threshold condition on prudent manner on a—to use this terrible phrase—"tick box" basis. You can come to work and say, "What is the capital ratio today? Is it above X?" Tick. "What is the particular liquidity ratio?" There are quite a few of them you have to look at, "Does it meet it?" However, of course, that does not answer the question. What answers the question is how robust is it, given its starting position, to the threats that you can conceivably see coming ahead. That is what we have to do more of and that is what we do more of.

Q28 Teresa Pearce: Given that we all know that there were issues with Barclays and that they were meant to be gaming the FSA, how will your supervision differ so that it will find when someone is gaming? It was not seen at all, was it, in the past?
Andrew Bailey: First, the key thing there is, to go back to what I said earlier about being focused on the key risks that this firm poses to our objectives and not to be covering a huge landscape of what I might call compliance issues. That is for the firm to do. The second thing then is to be prepared, through that focus, to "call it" and say, "Look, we have observed patterns of behaviour that lead us to conclude that you are the wrong side of the line in terms of the risks you pose".
The third thing that follows from that—and this in many ways, for me, is the major lesson from the Barclays issue—is being close enough to understand the practice and substance of governance as opposed to the form of governance; to be able to understand why these things are happening—in essence, do we understand which buttons we press on the board to get some response? We have to do all those things.
Views differ on this. I am not a supporter of supervisors sitting in the back row at boards observing them at work, largely for the reason that if I was in that position I would behave differently if a supervisor was in the room and if they were not.

Teresa Pearce: The culture is how you behave when no one is watching.
Andrew Bailey: I am a strong supporter, as you know, of us going to boards and talking to boards and saying, “You need to know these are the key things that we are focused on”.

Q29 Teresa Pearce: Given that your objective is to avoid adverse effect on the stability of the UK but there is no objective for having regard to growth, do you think that is an issue? Do you think that is a missed opportunity?
Andrew Bailey: The Financial Policy Committee does have, as you know, what I might call the hierarchical objective. Much like the Monetary Policy Committee, it has the hierarchical objective. It has the financial stability objective and then, subject to that, the very similar objective that the MPC has. I think that is a very important piece of the architecture. We do take that very seriously and we should take that very seriously. In the context of the interface between the FPC and the Prudential Supervisory Authority, I strongly believe that you have to have a stable, well-capitalised financial system to support lending and to support growth but we obviously have to get that balance correct. That does feed through into the PRA because the FPC will give us recommendations on that front.

Q30 Teresa Pearce: Just one last question. Pension funds are extremely important to all of us and the whole country. One of the issues that concerns me at the moment is that we are moving to a low-carbon economy and there are, I think, 100 listed coal companies and the top 100 listed oil companies, listed in the UK, which currently have more carbon in them than they can possibly burn, and there is this carbon bubble in the way that they are valued. Obviously that is not something you want to discuss at the moment but is it something you would take away and consider about the valuation—
Andrew Bailey: I am happy to do so, but it is a question for Martin Wheatley because he is responsible for markets regulation for the UK Listing Authority.

Q31 Teresa Pearce: However, you have an insurance role. What I am trying to say is this is a risk to the market that surely all of you, in all branches coming under the Bank of England and MPC, would consider going forward because you have spoken—
Andrew Bailey: I am happy to consider it in this case. If it is possible that there will be some major correction in this area that would have an impact on the financial system—
Teresa Pearce: Particularly pension funds.
Andrew Bailey:—then yes. I think we ought to discuss that also with Martin because a lot of that is—
Teresa Pearce: The reason I raised it with you is because you were saying when you are looking at firms, rather than what they benchmarked for the past, you will be looking at the future—
Andrew Bailey: Yes.
Teresa Pearce:—and it is something that would be of consideration. So, just to keep it in your head.
Andrew Bailey: I know we have had some correspondence from others on this subject and we have done some assessment of it. I think, for the most part, we thought it probably fell into Martin’s area but we will take it away.
Teresa Pearce: I shall write to him, with the Chair’s permission.
Andrew Bailey: He will thank me for that one.

Q32 Mr Love: Good afternoon, Mr Bailey.
Andrew Bailey: Good afternoon.
Mr Love: In November the Financial Policy Committee asked the FSA to look at whether banks and building societies needed to strengthen their capital base. What can you tell us about the results you have come across so far?
Andrew Bailey: I can tell you that the FPC is now into the round of looking at the assessment that has been done. I am honestly not going to tell you is in the substance of that, and the reason I am not going to tell you what the substance of that is because I think that the FPC has to perform its function and then be accountable to you for what it does. We are in the midst of that process. I read Mr Peston’s blog before I came here and he seems to know what we are doing. I can’t tell you whether that is true or not. However, we are in the middle of that and we will announce the outcome on 27 March, if I remember rightly. Then you should hold us accountable for it.
Mr Love: Absolutely.
Andrew Bailey: You will.
Mr Love: We were just trying to get in early.
Andrew Bailey: I know you were just trying to get in early. Nice try.

Q33 Mr Love: You can confirm to us that there is a need to strengthen the capital position and perhaps you can say just a little bit about whether the order of magnitude that has been suggested is somewhere between £20 billion and £50 billion. Can you say a little bit about whether we are in the right ballpark?
Andrew Bailey: I can tell you that I agree will be part of the consensus view on the FPC that there is a need to strengthen the capital position but I am not going to get into where the number is.

Q34 Mr Love: I want to go on and ask you about restructuring, but in the response to the Banking Commission on this particular issue, you drew a distinction between different institutions and you suggested that where an institution did not have a fully sustainable business model, they would have to look at restructuring before they went to their capital markets.
Andrew Bailey: Yes.
Mr Love: Did you have any institutions in mind when you said that?
Andrew Bailey: I think that it fits with the issue of how the state-owned institutions come out of state ownership. Many universal banks are shrinking their investment banking activities, and that is sensible and reflects the fact that there has been a change in the terms of trade of doing investment banking. The relative capital requirements on investment banking have increased. That is a point that is relevant,

whether they are state owned or privately owned. That is one restructuring point, but the second one, particularly, is that it is sensible to undertake any necessary restructuring measures as a precursor to being able to raise capital, and as a precursor to what I think everybody wants to see, which is to get these institutions back into the private sector.

Q35 Mr Love: There has been a lot of discussion about the issue of core assets and non-core assets, particularly in RBS. In your estimation or in the FSA's estimation, are these institutions going fast enough? There is a lot of debate and controversy around about how fast they are realising their non-core assets.
Andrew Bailey: Yes. If you take the case of RBS it is very interesting. Since the end of 2008, RBS has reduced its total balance sheet by around about £900 billion and it has reduced its funded assets—the bit that strips derivatives out—by about £400 billion. That is a major change and I think the management of RBS deserves the credit for doing that. It has run very much on plan and in some areas it has probably run ahead of plan. The numbers are smaller because it is a different institution but Lloyds too has been aggressive in running down the non-core assets and that is sensible. That gives you the platform then to say, "So, how do we take it from there to get the thing back into private ownership?" That is a good outcome.

Q36 Mr Love: I have taken RBS as an example. They have recently announced they are thinking along the lines of having an IPO for their American subsidiary, Citizens Bank. The suggestion is that Citizens would be more prepared for an IPO in a year or two years' time but the pressure is now on. Is the pressure from the regulator leading to them considering this now?
Andrew Bailey: It is quite well known that I have spoken to them about this but you must realise that ultimately those are decisions that the board of RBS took. The board of RBS, essentially, as I read it, has said three things. It has said that it is going to, as you say, get Citizens into a position where there is either an IPO or a trade sale. It has announced that it is going to restructure and reduce the size of its investment bank. I think that is sensible because, again, what they should be looking at and are looking at is an investment banking operation that effectively fits an institution that would be a major corporate and retail bank with a UK focus. It will not just be in the UK, but it will have a much greater UK focus in the future than it has in the past. The third thing that led from that was the board saying that, in their view, that put them in the position to contemplate starting to sell the Government shareholding and that is the right thing to do. I entirely welcome the fact that they have done that. Have we had conversations on those subjects? Yes, we have.

Q37 Mr Love: One final question. There has been a lot of talk about whether the Government would put fresh capital into either RBS or Lloyds. There is a concern out there that if the sale of assets does not raise as much as has been hoped, if those institutions have difficulty in going to the markets and raising enough capital, the Government may be forced into providing capital to strengthen their balance sheets. Is that a concern for the regulator?
Andrew Bailey: I have not asked the Government to put capital into RBS or Lloyds. You would have to understand what our position and our responsibility is. If and when plans are put in place to take the institutions back into the private sector then, going back to the earlier question, of course the state in which they go back into the private sector has to be one in which they meet the threshold conditions. That is our responsibility. They have to meet the prudent manner threshold conditions. We would obviously look very closely at the capital and funding position and so on of the entity that was being take back into the private sector, but I can assure you I have not asked the Government to put money in at this point.

Q38 Mark Garnier: May I turn to real estate, mortgages and loans, and the thorny issue of forbearance? The November 2012 Financial Stability Report was talking about around a third of British commercial real estate loans being now subject to forbearance. First, how long has the FSA been aware of this? Did they only just spot it in November? Secondly, and possibly more importantly, how does this compare with previous slow-downs?
Andrew Bailey: We did what I might call, a real drains-up on forbearance last year. It is as broad a definition of forbearance as we could come up with. There is not a precise definition. It is when something has happened to the terms of the contract that changes the terms of the contract. The devil is in the detail with defining forbearance. I found this out in my early days dealing with Northern Rock when it took us ages to find out what they had been up to.
I think then the question is this. There is clearly sensible forbearance from the point of view of borrowers when it is in the best interests of the borrower and the lender that there is a change to the terms of the contract, if you like. Our position is that I am entirely supportive of banks doing that. We do, however—and this comes back to the question of recognising provisions—want to ensure that when they do that they understand the impact on the valuation of the asset and recognise it.
The point you make about how does this compare with past times is interesting. This is a very different pattern of recession from the ones that we have had in the past. The recessions of the past, of course, have been far more ones where the interest rates were higher and, therefore, debt servicing costs were higher. If you go back to the experience of the early 1990s, for instance, the rate of arrears and repossessions was much higher than it has been. We know why, because obviously the effect of low interest rates means that borrowers can service the debt. The consequence of that is that the pattern of behaviour, I think, has been quite different during this recession and that is fine. One of the things that we have to watch quite carefully, and this comes back to the issue of models the banks use, is how they weight the various patterns of behaviour, in terms of calculating the amount of capital they require.

Most banks' mortgage models work off the early 1990s, so most of them assess the realised rate of loss in the early 1990s on mortgages and use that as a benchmark for what the capital requirement is. That may not be silly. We look at it quite carefully and sometimes put add-ons in. The question then becomes very much: how long is this pattern of interest rates going to last, and what would be the effects, given the amount of forbearance that has built up, on a change in interest rates? That is the important question in terms of assessing the pattern of losses. Certainly, if you look at it straightforwardly at the moment, you would think this is a very benign experience for a system, but we know why. It is down to, quite deliberately, the impact of very low interest rates.

Q39 Mark Garnier: Quite. Of course, this raises a huge number of further questions. The first thing is I completely accept your point that if you have a very genuine reason, the bank would want to help their customers through the cycle, and that is quite understandable and a normal business approach. Nevertheless, what is slightly worrying, of course, is how many of those banks are helping the so-called "zombie" companies, not necessarily through a cycle but just trying to kick this problem further down the road. The second point is low interest rates. It is obviously that much cheaper for a bank to exercise forbearance than it would have been in a higher interest rate environment and, therefore, there are fewer day-to-day problems for them.
Andrew Bailey: Yes.
Mark Garnier: However that, of course, comes up with the even bigger risk, which is when interest rates inevitably start to go up at some point in the future. I have made this point in the past: we are in a super-low interest rate environment. If we return to a normal period of low interest rate environment we can see a doubling and a tripling of the cost of capital for these things. Do you not have serious worries about what is going to happen when interest rates start to pick up?
Andrew Bailey: Obviously, that is why it is important to apply what tends to be, in the jargon, called the "through the cycle" approach, because, you are right—and I think history tends to bear this out and certainly if you talk to the old bankers they will tell you this—the highest rates of company failures tend to be as you are coming out of the recession, as the forbearance ends and, as you say, as interest rate conditions tend to return, particularly in this environment, to their more normal pattern. It is quite interesting. I was involved, back in my previous role in the Bank, in the so-called London Approach that the Bank of England has done for ages, which is knocking heads together when companies get into difficulties with organising debt refinancing.
The banks all have this thing about good companies do not fail. They restructure them, but some business models just run out. They will tell you that it has not been particularly because of the debt side of the contract; it is that the rationale for the business model has run out. I go back to your question. We are very focused on the risks of a return, obviously, of the interest rate level and also, I should say, the way in which that happens. If you go back to 1994, I think it was, where you had a very sudden spike up in the slope of the yield curve, that was a quite difficult experience and going back to the earlier question, this is also relevant for the insurance industry. What happens over the long run when interest rates return to normal? That is one issue. If there is a sudden shift in the yield curve, what does that do? That is another issue.
Mark Garnier: It could easily happen.
Andrew Bailey: It could happen, obviously.
Mark Garnier: The other key point, of course, is we have been having this forbearance, potentially now, for five years and that in itself is pretty unprecedented as well.
Andrew Bailey: Yes.

Q40 Mark Garnier: Can I just turn this slightly from commercial real estate to residential real estate, which is also quite important. We have £1.2 trillion worth of household mortgage debt and £1.6 trillion worth of aggregate household debt, including mortgage debt, which, again, is pretty unprecedented, is it not?
Andrew Bailey: Yes.
Mark Garnier: They are very high levels. I understand that 40% of residential mortgages are now interest only and do not necessarily have a repayment plan alongside them. Twenty-five years ago, I suppose, in halcyon days when money was a bit tighter, a mortgage on a property was a savings scheme, ultimately. Now, 40% of people who own homes are not saving, effectively, because they are not going to pay off their mortgages. The first part of my question is what happens, when interest rates go up, to households, given that, to a certain extent, forbearance could be self-imposed by people going to interest-only mortgages, but, again, we may now have people who will be kicking that can even further down the road? Are we not just building up enormous problems for ourselves that we are not tackling today, and we are going to have to deal with them either when interest rates start going up or, probably just as importantly, when people start having to pay back these loans?
Andrew Bailey: I have a lot of sympathy with the point you make. One of the fascinating but, as you say, quite disturbing elements of this entire story is what I call the long-term intergenerational transfers that are going on and the effects of this. When I talk to new graduates at the Bank of England I say, "Look, I have bad news for you. You are going to be working for a lot longer than your predecessors." It is very interesting how—
Mark Garnier: That is an easy answer to the question.
Andrew Bailey: It is true, but it is a trite answer. What you are also going to see, as you say, is a pattern of indebtedness that is going to go on far more through people's lifetimes and cause more problems for people than they did expect. That is one of the things that has been built in in the system.
Mark Garnier: Do you think we have a crisis facing us?
Andrew Bailey: I do not think we have a crisis today, but I think we have a very different pattern of behaviour and outlook from that we thought we had probably 10 years ago.

Q41 Mark Garnier: My last question. Do you think politicians are being chicken in terms of dealing with this potential crisis?
Andrew Bailey: This one?
Mark Garnier: Yes, the accumulation of debt.
Andrew Bailey: It would be trite and I would have to run out of the room quickly if I said you all have very short-term outlooks. You know this better than I do. I think, for all of us, it is always easier and more pressing to concentrate on the problem that is going to hit us next week than the one that is going to hit us in 10 years' time.
Mark Garnier: However, if we do not think about what is going to happen in 10 years' time, the problem then will be 10 times as big.
Andrew Bailey: Yes. It would be worth all of us spending more time on these issues to try and work out what we are going to face and what we are going to do about it.
Mark Garnier: Will this be part of your job?
Andrew Bailey: Yes.

Q42 Mr McFadden: We sent you some questions when you were asked to the session and you have written some very full replies. I would like to ask you a few questions about the document that you sent back.
Andrew Bailey: Certainly. I have a copy in front of me.
Mr McFadden: The second question was about your previous experience. At the bottom of the first page of the document you say you have experience in resolving failing banks and, "There are few better learning opportunities than to be responsible for resolving failing banks." In your experience in doing this, what are the main one or two things that stand out in terms of the lessons that resolving failing banks have taught you?
Andrew Bailey: As well as the obvious problems with banks that become under-capitalised and reliant on short-term funding, I think what you also see when you do resolution, because you have to get into the guts of institutions, one of the other things that I am afraid I think is a problem that is in the system—and this goes back to the long term problems and I am not singling any one of them out now because this is across the board—is that these are very big institutions with very complicated infrastructures. Broadly, they keep going from day to day and, of course, a lot of them have grown by acquisition—not all of them, but quite a lot of them—which has involved bolting things together. When you get into resolution you have to face, "Do we have to cut these things up? How do we deal with them? How do we keep things going when the institution is failing?" You realise the sheer complexity of dealing with these institutions and I think there is a legacy problem in there, there is no question about it, but you do learn a lot doing that. You learn a lot about how the basic infrastructure of these institutions works or does not work.

Q43 Mr McFadden: In the various reforms that have been put in place, ring-fencing, new capital rules, new resolution mechanisms and so on, do you think there is a danger of the public's misunderstanding that these are about making sure banks cannot fail in the future. You stressed in the note that people should be wary of this misunderstanding and that the point of all this reform activity is not to make failure not an option, but eventually to make it an orderly option. Can you say a bit more about that?
Andrew Bailey: Yes. I think there is a potential to get a wrong message across—not that I think, by the way, the Commission has done this—that the ring-fenced bank is somehow risk-free and all the risk has been put outside the ring-fence because that is where you want all the risk. Of course, that is not the case. There are different risks. The whole point about it is having different risks inside and outside the ring-fence and being able to deal with and manage those risks separately, and potentially to be able to resolve things at the institution separately by virtue of having the split. Although, the history of UK banking tells us—as some of the critics of ring-fencing sometimes point out although I do not think it is a criticism of ring-fencing, they use it in a slightly self-serving fashion—that, of course, more of the failures in this country have come from failures of what ought to be fairly straightforward mortgage banks, for instance, than of complex trading books.

Q44 Mr McFadden: That is a communication challenge, definitely, and you refer to other communications challenges in this note as well. In question 7 on page 7 you talk about the interim FPC and we have had some questions this afternoon about the bank balance sheets and more capital for them, and so on. What do you mean when you say, "The FPC will need to consider its style of communication and invest heavily in building an understanding among the public"?
Andrew Bailey: I think that one of the successes of the MPC right from day one was to invest very heavily in explaining to the public what the objective was, what the MPC did, what it did not do, and to do this very rigorously. It was one of the reasons why both Eddie George and Mervyn King put so much emphasis on going around the country doing it and not just sitting in London doing it. There was a very determined campaign, which has gone on, to explain the objectives, the framework, the tools, and so on. Interestingly, first, I think the FPC has to do that. It is more complicated for the FPC. It is very interesting to compare the two.
Monetary policy is an analytically complex activity, but it does lead to a single decision. Obviously, at the moment it is a single decision on a different variable. It is a different lever from that used than in normal times, but it is still a single decision on an outcome. Sitting in the FPC is quite interesting because you have a lot of levers. There is a whole array of levers in the FPC that you can pull and you can pull them in combination. I think that is perfectly sensible. That is right, but communicating what we are doing, what we are trying to do, and why we are doing it, first, less of it has been done but, secondly, it is more complicated.
Mr McFadden: This is true of this alphabet soup in general, is it not? We have the PRA, the FPC, the FCA. You would have to be a pretty interested

member of the public to follow what all these are and what they are for.
Andrew Bailey: Yes.
Mr McFadden: Do you think that is a problem?
Andrew Bailey: I am off to Belfast for the next two days to have a go, so I will tell you. I think it is a challenge, do not get me wrong, but I think it is a challenge we have to take on.

Q45 Mr McFadden: Jumping around a little bit, later in the document you talk about judgment-led supervision and so on. I am looking particularly, if you want to look at it, at question 12 on page 11. You talk about your experience with Barclays and about how there was, in what has become quite a well-known quote from you, "a culture of gaming the FSA" at Barclays.
Andrew Bailey: Yes.
Mr McFadden: Were they the only ones? Have you found other banks that had the same culture of gaming the system, of gaming you as a regulator?
Andrew Bailey: I think that they were furthest out, by some way, along the curve. I want to be careful what I say because I do not want to tar others with that sort of accusation. However, it is in the culture of a detailed rules system—and it goes back to the point I was making about remuneration earlier on—that you can get almost an orthodoxy of culture built up that if you can find a way around a rule, it is okay. I will give you an example. The first end year I was at the FSA was 2011. Bear in mind, the banks have end-of-years runs that are the end of the calendar year, and many of them have a sort of a capital ratio in mind that they want to sort of report to the world. What happened as we got towards Christmas, the model-change requests started coming in. I think I mentioned this last week. I am not going to use the word "outrageous gaming". If you create that sort of rules-based system and you do not apply an overlay of judgment, of course, all the incentives are stacked up to do that sort of thing.

Q46 Mr McFadden: You say this throughout the document. You talk about Europe having this huge harvest of data. Do you think there is a potential big mistake that regulators are going to make in the wake of the crisis, which is that, to cover their backs partly, they ask for more and more data and then, drowning in the data, they squeeze out the judgment or the governor's eyebrows if you want to call it that. They squeeze out the essential smell test.
Andrew Bailey: To be honest with you, one of the biggest threats we face in what we are trying to do—I will be careful, because this point can come across as very anti-European—is there is a different sort of trajectory among many involved in the EU processes who want to create more and more rules, because they see that as the way to sort of—
Mr McFadden: Is it only the EU?
Andrew Bailey: In my experience, it is probably most extreme there because they are, in a sense, dealing with a different problem.
Mr McFadden: There is nobody in the UK asking for more and more data?
Andrew Bailey: I was meaning rules. The EU data requirements for banks in quite a few areas are 10 times our data requirements.
Mr McFadden: That is what you said.
Andrew Bailey: Yes. However, they are trying to solve a different problem, which is how you standardise across 27 countries. They are trying to discipline a process across countries. Frankly, I am deeply sceptical of whether you can do that by more and more rule-making.

Q47 Mr McFadden: I think we are coming to the end, but if I can just finish on this. You have heard a lot of discussions between other operations, the Banking Commission and so on, recently about new entrants and the desire for competition and the concerns over the concentration of the UK banking system. You made quite a pointed remark on this. It is at the bottom of page 14 and top of page 15, where you talk about greater competition, but it must be based on robust and sustainable institutions: "I want to see a more diverse banking system, but not at any cost." Are you saying there is a danger that, in our desire to see more players in this market, we allow weak institutions who will increase risk in the system to—
Andrew Bailey: The point I made there is an illustration from history. If you go back before the crisis, there were two things—in a sense, the UK has had a concentrated banking system for a long time—that led to an increase in competition in the UK banking system. One was the demutualisation of building societies and the other was the entry of some banks from other countries. Today no demutualised building society exists as an independent entity and most of them had a bad end. That was a model of competition that failed, so I do not want to repeat that model.
Mr McFadden: None of them survived.
Andrew Bailey: None of them survives today. There is no independent demutualised building society in this country today. Some of the foreign banks have obviously stayed, but we saw the Icelandic experience.

Q48 Chair: Just on the Europe point that you were making a moment ago, in your evidence on page 12 you make clear it is not just in the bonuses field that they are getting it wrong. You say, "I see a pressure to create more binding rules at an ever more detailed level and to use the so-called maximum harmonisation approach, which means that the rules set both the minimum and the maximum standards". You clearly do not like that. You then go on to say—you are pretty robust—"I do not see ever more detailed rule-making as a sustainable solution to the identified problems"—that is, the problems of banking and supervision, and the next part of the sentence is even more telling—"nor is it necessary to achieve the free trade objectives of the single market". You are basically saying, are you not, the EU should get out of some of this territory?
Andrew Bailey: We are trying to apply what I call judgment against a framework of rules. There have to be rules because clearly our actions have to be, firstly,

defensible and, secondly, predictable, but there is judgment in there. I think the danger of going down the "ever more rules" approach is that it does not work in the end. It falls over under its own weight. There is a huge pressure at the moment in Europe on this. It is quite interesting that a lot of the debate on the banking union in this country is about the UK position vis-à-vis the banking union.

I am on the management board of the European Banking Authority. When you sit there what you see is a different debate, which is what I call the pressure from the single market institutions and the European Commission to make rules to hold the single market together against authorities involved in supervision like ourselves—and maybe as the ECB will become when it is the single supervisor in the mechanism—who are trying to use judgmental supervision to achieve financial stability. That is a real tension. That is the biggest tension I observe at the moment, not the tension between us and ECB. There is not a tension between us and the ECB. It is the scope of rule-making, and the reason I say this, I do not think the problems that beset the single market are banking supervision problems. They are, at root, macroeconomic problems.

I do not think you can use rule-making and banking supervision to solve those problems. You have to solve those problems through other actions. There is no question that the single market is fraying. There is absolutely no question. I hold my hand up. We are doing it and others are doing it. We have to take certain defensive actions to protect our statutory objectives and to protect the users of the banking system in this country. That tension over rule-making is a big one.

Q49 Chair: It is a very interesting point. You are also making the point, are you not, that they are going beyond what is required to complete the single market?

Andrew Bailey: Yes.

Chair: You might be reluctant to do this, but it might be helpful if you would be prepared to set down on a piece of paper what you think the minimum necessary areas of EU activity are for completion of their objectives. Then, maybe alongside, you could list the things that you think fall outside that are currently being undertaken.

Andrew Bailey: Yes. It is also how far you drill down through all this. It is not necessarily, "Do you have that thing in or out?" It is also how far you make the rules themselves drill down. I will have a go.

Q50 Chair: Thank you. If we turn to page 14 of your evidence, just a bit higher up from the point at which Pat McFadden was asking you questions, you discussed the PRA veto of SCA activity. This is what you describe as an entirely hypothetical scenario. I presume that is put in because you want to make sure people do not mistake it to apply to PPI?

Andrew Bailey: Absolutely.

Chair: Do you not think that this power, when exercised by the Bank of England, whoever it may be in the Bank, is going to be seen as a criticism of the FCA and, therefore, weaken the FCA as an institution?

Andrew Bailey: No. I will give you an example that could have happened in the past. I can see a situation where the FCA say, "Look, this is what our statutory objectives tell us we should do". It is interesting about your role in this. Rather than have some sort of smoke filled room deal between me and Martin Wheatley that we then sort of do not reveal to you or only partially reveal to you, it may well be better for both the FCA and the PRA if at that point the veto is used transparently. I do not think that would be a failing of the FCA because I think the FCA would be saying, "Our statutory objective leads us to this conclusion", and the PRA says, "Our statutory objective, I am afraid, leads us to have to say we cannot do that". The case I am—

Chair: I am sorry to interrupt. In that case we would need some kind of requirement on both institutions, should there be pressure that they consider amounts to serious consideration of the veto, for that to be raised with the Treasury Committee.

Andrew Bailey: Yes, we should be completely transparent to you.

Chair: You think that would be appropriate?

Andrew Bailey: Yes.

Chair: We would need that prior to the moment at which the veto is exercised.

Andrew Bailey: I do not know. I would have to think about that. That is an interesting question. Let us assume this regime was in place at the time, which it was not, you remember the legal action on overdraft charges that was back in 2008, I think. I am not revealing anything that is not in the public domain. Had it gone the other way, that could have led to a bill, in terms of the cost to the banking system, that was, in some estimates, sufficiently large that it would have raised a financial stability and prudential issue; particularly, of course, given the state of the system at that time. Had that all come to pass and had we had that regime in place, I think that is an occasion in which the veto could have been used. The interesting question in that is, what would be the effect of using the veto? It may well be to say, "Look, we understand there is this amount of redress. We are going to have to deal with this over some period of time because, otherwise, we are going to have adverse consequences for the stability of the system that are too large to manage in the alternative way".

Chair: This is an interesting example because it is an industry-wide example.

Andrew Bailey: Yes.

Q51 Chair: Do you not think that in judgments about the whole industry, and indeed generally, the better place for the judgment to be made is the FPC rather than the PRA? Have you not just made the case yourself, by drawing an example for the whole industry rather than an individual institution?

Andrew Bailey: Yes, I think that is a case in which the FPC would have had to consider that in the context of its statutory objectives.

Chair: We have proposed this, as you know, and the Government have batted it away. It will be interesting to see what you think about it.

Andrew Bailey: I am trying to think at the moment, if we had this current system—it is an interesting question. The PRA on its own has the mechanisms for dealing with it, so you might say it does not need the FPC to intervene because it would draw the conclusion anyway. The FPC, however, in its consideration of risks to the system, had it been—I am not saying its institutional architecture was in place then and of course, it was known in advance that there was the risk because obviously, the court case was going on. I do not think you need to change anything in the current institutional setup for the FPC to be able to consider that.

Chair: The question is: where does the authority lie for the exercise of the veto?

Andrew Bailey: It lies with the PRA.

Chair: I know, but I am asking you whether you think it should lie with the FPC.

Andrew Bailey: I do not think that is a problem. I do not think the FPC, in the current environment, could give the PRA a recommendation or a directive to use the veto.

Chair: No. I am asking you whether the veto, if there is to be one, should lie with the FPC.

Andrew Bailey: I do not think it has to, no. I think the PRA can use the veto—

Chair: Might preferably lie with the FPC.

Andrew Bailey: I think that is a bit difficult because I think that you have to combine both a sort of system-wide impact and an individual institution impact. Yes, maybe this is coming at the same issue from two different sides. I would be quite happy—this is how the system works—for the FPC to give a system-wide view to the PRA and say, "You should be very concerned about this." What the FPC cannot do is say, "And you should be concerned about institution X because that is outside the FPC's remit".

Chair: Thank you very much for your typically frank and thoughtful evidence, like the written responses to our questionnaire. The Committee is very grateful.

Written evidence

Mr Andrew Bailey's responses to the Treasury Committee's questionnaire

1. *Do you intend to serve the full term for which you have been appointed?*

Yes, I intend to serve the full term. I have a record of seeing jobs through in the Bank of England. I took over as Chief Cashier of the Bank at the end of 2003 in quite difficult circumstances and spent just over seven years in the role. I am very proud of what the Banking Directorate achieved during that time. My approach to the PRA-to-be has been similar over the last, nearly, two years, and I can assure you I will stick to the task.

2. *Please explain how your experience to date has equipped you to fulfil your responsibilities (a) as Deputy Governor for Prudential Regulation and (b) as a member of the Financial Policy Committee.*

Let me start with the role of Deputy Governor for Prudential Regulation and Chief Executive of the PRA.

I have experience in prudential regulation going back to the late 1980s. For around four years at that time I was heavily involved in the implementation of Basel I and subsequent agreements on the policies towards market risk and group supervision. During this period, I was also heavily involved in international policy negotiations. From this, I developed a strong understanding of the basic building blocks of prudential supervision, and the strengths and weaknesses of the Basel I framework.

Subsequently, I had a long period of my career when I was not involved in prudential supervision but had a series of roles in the Bank of England, all of which have provided valuable experience for my new job. I had two periods working in the Banking Directorate, latterly as Chief Cashier, which—I like to think coincidentally—have been times when the Bank has been involved in resolving failed banks. The first period covered the resolution of National Mortgage Bank (my first), and the Bank of England's "behind the scenes" operations to manage the failure of Barings for which I was responsible. The second period, as Chief Cashier, coincided—in my later years in the role—with the financial crisis, during which I led the Bank's support operations and resolution actions for failing banks. These experiences have been invaluable in helping me to understand how banks do (and do not) work effectively. There are in my view few better learning opportunities than to be responsible for resolving failing banks.

During the crisis period I therefore had to manage and take responsibility for very difficult and high-profile operations. I was also responsible for the Bank of England's use of the so-called London Approach, under which it can apply its powers of persuasion to overcome problems of lender co-ordination in the restructuring of company debt. This provided me with very valuable insights into the issues around loan restructuring for non-banks.

During the second half of the 1990s I was Private Secretary to the then Governor, Eddie George. This included the period in 1997 when the Bank was given independent responsibility for monetary policy, and the creation of the FSA (the latter in more difficult circumstances). Having been present at many of the founding moments of the Tripartite system, I can well understand why the system suffered from structural failings which ultimately damaged the response of the UK authorities to the crisis.

My time in charge of resolution at the Bank during the crisis obviously gave me a close insight into the working of the FSA and the difficulties it had experienced with prudential supervision. I felt that this meant it was sensible for me to play a role in the new arrangements when the Government announced the changes to financial regulation. To that end, I joined the FSA at the end of March 2011 (though retaining my position as an Executive Director of the Bank of England in view of my responsibilities there for the work to create the PRA) in the role of Director responsible for prudential supervision of banks and Deputy Chief Executive Designate. Just over a year later, when Hector Sants left the FSA, I became Managing Director for prudential supervision covering the full scope of the PRA-to-be. It was around that time that the FSA implemented so-called Internal Twin Peaks, creating the shadow FCA and PRA run by Martin Wheatley and me reporting to Adair Turner. For the last year I have therefore been undertaking much of the future role of Chief Executive of the PRA. This has obviously given me a great deal of experience of what is likely to lie ahead. It also means that I have taken the leading role in creating the PRA as an institution.

I can cover the FPC more briefly since a good deal of the experience described above is relevant. I have been a member of the Interim FPC since last Spring. Between 1999 and 2004 I was Head of the Bank of England's International Economic Analysis Division, and while the work of this Division was to serve the MPC, it required the intellectual and analytical rigour that also marks out the FPC. Moreover, before joining the Bank in 1985 I had a university research background.

Summing up, my career has combined analytical experience and a strong background in managing operations. As Chief Cashier I was responsible for managing the Bank's banking, payments and banknote operations as well as bank resolution, amounting to around 450 staff. I have therefore substantial experience in getting things done.

3. *Which of your speeches or publications are of most relevance to your future roles?*

The following are speeches and papers that have been published which I think are most relevant to how I intend the PRA to operate, and how I will carry out the role.

Documents

PRA Approach to banking supervision (October 2012)

PRA Approach to insurance supervision (October 2012)

Insurance supervision

The evolution of insurance regulation: a shifting scope and new frontiers (February 2013)

Banking supervision

Prudential regulation: challenges for the future (October 2012)

The future of banking regulation in the UK (October 2012)

The challenges in assessing capital requirements for banks (November 2012)

4. *What do you regard as the main challenges that you will face as Deputy Governor of the Bank of England and chief executive of the Prudential Regulation Authority in the next five years? What criteria should be used to assess your record?*

I see two main challenges ahead, and I stress that there is no order of importance here as they rank equally in my view.

The first challenge is to promote the objectives given to the Bank for financial stability. This means building two successful and lasting institutions within the Bank, the PRA and the FPC. Parliament has given the PRA clear objectives around the safety and soundness of banks, insurers and major investment firms, and the protection of insurance policyholders. For banks, our objective will be amended as a consequence of the legislation to implement the recommendations of the Independent Commission on Banking.

Our general objective is to build a resilient financial system in which the public can have confidence that they will have access to the critical financial services on which they depend. An important and necessary complement to a safe and sound financial system is one in which financial institutions support the growth of credit and investment in the economy. I should emphasise that my focus here is as much on the insurance industry as it is on the banks. Insurance and risk transfer services are just as critical to a stable financial system. I am by comparison new to insurance, but I take it very seriously.

I have been responsible for setting out the PRA's approach to microprudential supervision, notably in the two documents (covering banking and insurance) that we published last autumn. These documents set out our emphasis on supervisory judgement applied against a framework of rules, but not an emphasis on more and more rules as a means to create compliance by firms. Judgement needs to be applied in an open and fair way, and it is vital that the PRA is transparent and accountable for its actions. I put great emphasis on explaining to our staff, senior executives, board of firms and all interested parties that our supervision of firms is focused on the key threats to the PRA's statutory objectives. We must be focused, and we must avoid the sort of detail that causes supervision to lose sight of its objectives.

Judgement is an easy word to use, but it comes with challenges and we must recognise these and deal with them. We must apply judgement in a way that does not create unnecessary uncertainty. Judgement is important because we must be forward-looking, focused on the key risks to firms in terms of our objectives. But we must not allow that to create uncertainty over our likely reactions. That said, judgement can in my view be helpful in countering a culture of gaming which arises from undue reliance on rules. And, we must remember that we are supervising at least one industry which is notable for its use of imaginative innovation.

The main challenge to judgement in my view comes from an approach in Europe which seeks to use detailed rules and so-called maximum harmonisation to create consistency in supervision. I do not think this will work as intended as an approach, and I hope that we can persuade the European institutions that their best interest lies in having strong supervisory institutions that can apply judgement sensibly. It is with this hope in mind that I support the role of the ECB in the Banking Union. That said, we must be alert to the risk that other European institutions will apply pressure to adopt the approach of detailed rules.

The PRA approach to supervision is also one in which it is intended that financial institutions can fail, but that, if they do, their failure will be controlled and will not threaten the stability of the financial system. There is, of course, major work that remains to be done here, to remove state subsidy and too big/important to fail. I am fully committed to continuing to play an important part in contributing to the development of a resolution regime that can credibly achieve the end of state support. An important part of this work is also the finalisation and implementation of the legislation to implement the recommendations of the ICB.

Turning to the FPC, it is vital that macroprudential policy is effective as a complement to and alongside microprudential supervision in the PRA. Put simply, the success of the FPC means that macroprudential policy is no longer essay writing but has real operational impact in terms of its recommendations and directives. This requires rigorous assessment of risks and vulnerabilities, application of those in quantified form using, for instance, stress tests of the financial system, and a stronger understanding of risks from outside the boundaries of regulated activities. The FPC has to ask hard questions on the structure of the system, and it has to avoid too great a focus on fighting the last war. As an example, we have been through a major prudential crisis in terms of financial positions of firms, and then more recently very serious events resulting from past misconduct by firms, but we should not forget the possible impact of, for instance, cyber attacks.

As Deputy Governor of the Bank, I will also be responsible, with the Governor and other Deputy Governors for leading the institution through a period of major change. I look forward to this. The Bank has great strengths as an institution which come from its reputation, and from the quality of its staff. I am very excited that a new group of staff will be joining the Bank, and I am confident that the PRA and its staff can contribute to the new Bank. What stands out for me in the Bank and the PRA is a commitment to being very good at delivering our objectives. Much of the public profile of the Bank is naturally around the policy making functions which have a high media profile. I have also been lucky enough to work with very talented staff who deliver the Bank's operations, and most recently this has been evident in the delivery of the PRA in its new home in Moorgate.

The challenges ahead are to ensure the Bank can function in a world with more responsibilities which are effectively joined-up, to give our very talented staff opportunities to participate fully in advising on and delivering our decisions, and to ensure that the governance and accountability arrangements of the Bank deliver as promised.

In terms of how to assess my record when the time comes, I see this as very much in terms of creating stable and lasting institutional structures for financial regulation (macro and micro-prudential). The reforms of 1997 created a stable institutional structure for monetary policy, but they did not create the same legacy for financial regulation. We have another chance to do this, one that we must take.

5. *How would you describe your leadership style?*

I am unashamedly a hands-on leader, and I don't like being isolated from what is going on. I have had a lot of operational leadership experience, with the most pressure coming during difficult financial resolutions. That said, I have put great emphasis on recruiting and developing strong management teams throughout the areas that I have run. The PRA in my view starts with a strong management team which has a clear vision and commitment to our approach to supervision of firms. It is very important to have such a team who are, like me, committed to putting into effect supervision to pursue our statutory objectives, and to having an open style of communication and accountability.

I am also committed to running a tight ship in terms of the size and cost of the PRA. We have deliberately set out not to use the creation of the PRA as an excuse to expand prudential supervision and put up the cost to supervised firms. That is not part of our philosophy or objective and I believe it is consistent with the Bank of England's record of cost control. I thought it might therefore be helpful if I set out my thinking on the cost of the PRA.

The starting point was to set a budget for the PRA in its first year which is no higher than what we think the PRA would have cost during the next year under the current FSA set-up. To this end, we froze the PRA headcount early in the transition process (around two years ago) and have been vigorous in pursuing that approach since. Consistent with the Bank of England's general approach we have set a budget in future years which is no higher than a flat real cost of operation. This is the baseline approach we have taken for the PRA. There are a number of further points I would draw out on the PRA's budget:

- The flat real cost budget applies to our annual regular (or recurrent as we call them) costs. There are also non-recurrent costs for projects that are not expected to be permanent. Last year, the major element of these for the FSA was the cost of preparations to implement the EU Solvency 2 Directive for insurers. I have recently written to the Parliamentary Commission on Banking Standards on this subject, and would be happy for that letter to be shared with the Treasury Select Committee. Last year the FSA levied £15 million in respect of Solvency 2 costs. For the next year, we intend to levy just £0.1 million. The difference reflects cut backs that we have applied to Solvency 2 preparation costs. Although it is hard to be sure of the final cost of Solvency 2 preparations given the uncertainty on timing and substance, I expect the overall cost to be considerably lower than previously estimated. This will be a saving for insurers.
- In the early years of the PRA, we are using part of the budget to fund investment in systems which will replace those legacy FSA systems that the PRA will in the meantime continue to use. The PRA will also pay an annual fee to the FCA for the use of these systems. I expect that the cost of operating the new systems will be lower, though at this time I cannot estimate that saving.
- Likewise, in the early years of the PRA we will be recovering the costs of setting up the new arrangements, and this will fall away after five years.

— Finally, the PRA levypayers will have to bear their share of the legacy FSA pension deficit once a new valuation has been done. At this time, I do not have an estimate of this cost.

I hope that this description of the approach to the PRA's budget makes clear my commitment to keep a tight rein on spending. I also welcome the National Audit Office undertaking value for money assessments of the PRA once it is up and running.

Financial Stability and the Financial Policy Committee

6. *How would you define financial stability?*

The experiences of the financial crisis have caused many people, me included, to modify their definition and thinking about financial stability. Like quite a few people, I would now put more emphasis on a stable system being one which can continue to deliver critical financial services to the public without disruption and dislocation to the economy in the face of a wide range of severe shocks (both economic and operational). In this context, the PRA is charged with ensuring the safety and soundness of the firms for which it carries out prudential supervision, and for the protection of insurance policyholders. But we have also made clear that we do not intend to achieve financial stability by maintaining a regime in which firms cannot fail or one where the dependence on taxpayer support continues. We regard this as counter to establishing a healthy and stable financial system; rather, orderly failure in which firms do not disrupt the supply of critical financial services is consistent with the PRA's objectives.

7. *What do you regard as the strengths and weaknesses of the work undertaken by the interim FPC?*

The Interim FPC has been given two tasks: first a "paving" task in terms of setting out the tools that it thinks should be at its disposal, and the framework within which those tools should be used; and second, it has been functioning as the macroprudential regulator, albeit without the full set of eventual tools. The first activity is an important investment for the future, which has recently led to the publication of a discussion paper on "Instruments of Macroprudential Policy".

The FPC has two objectives, namely the resilience of the financial system and, subject to that supporting the economic policy of the Government, including its objectives for growth and employment. Resilience is defined in terms of taking action to remove or reduce identified systemic risks. The FPC has focused to date on, risks in the banking system, and in doing so has provided valuable guidance on the overall objectives of firm level liquidity policy in the banking system. Last June, the FPC and FSA provided clarity and guidance on how banks could expect to use their liquidity buffers; the FSA changed its stance on such buffers; and the Bank of England extended its liquidity insurance tools. I judge these interventions to show encouraging signs of success. To be clear, there is still a need to identify and seek to remedy blockages to small firm finance, but the last nine months have seen a change in bank's funding conditions and growth in loan availability, most notably in mortgage lending.

That said, the Interim FPC has been working in conditions where there remain questions over the appropriate levels of capital buffers to be maintained in banks. The recommendation given by the FPC to the FSA in November is in my view appropriate in that it frames the question around the proper valuation of assets, a realistic assessment of future conduct costs and prudent calculation of risk weights. None of these areas is easy in terms of determining appropriate levels of capital buffers to meet possible losses in the future, but the FPC has in my view asked the right questions in a way that will force a more consistent answer. This is the sort of discipline that was lacking in the previous system.

My assessment of the weakness of the FPC's approach to date in this area is that it took time to frame the question, and particularly in a way that can be explained to the public and financial markets. Regulators have to be very careful not to create unnecessary uncertainty, and I think the FPC will need to consider its style of communication, and will need to invest heavily in building an understanding among the public and a consensus in favour of its objective of resilience which can readily identify itself as such (ie active not just positive acceptance). The history of the MPC suggests that this task can be achieved, but we should bear in mind that the FPC has come in to being in much more difficult circumstances than was the case for the MPC, and it is operating in a field of policymaking which is less well defined than was the case for the MPC.

8. *How should the FPC communicate financial stability policy and decisions, in particular to the general public?*

There is no doubt that macroprudential policy is less well understood than monetary policy and in important ways is more complex to explain. In broad terms, the FPC can pull more levers, and thus its decisions do not reduce to a signal quantified outcome. I have given a number of speeches on this topic, some of which I have identified in the answer to Question 3, and I intend to continue to do so. I think that it is a duty of belonging to the FPC to take time to explain our objectives and activities to a wide range of audiences. Building a body of understanding and support for the FPC is vital work if we are to achieve the same institutional reputation that the MPC has achieved. As part of this work, I visit different parts of the UK, using the Bank's network of Agents, and spend time meeting with contacts who are interested to know more about the FPC and PRA. I have also sought to use media interview opportunities to promote the role of the FPC

9. *What is your assessment of the macroprudential tools that will be available to the FPC? Would you have preferred the FPC also to have the ability to limit loan to value and/or loan to income ratios?*

The FPC asked for three macroprudential instruments as direction powers: sectoral capital requirements, the leverage ratio and a power over the countercyclical capital buffer. The Government has proposed to grant the FPC these powers, although power over the leverage ratio will not be granted before 2018 (and subject to a review in 2017). These three tools are an appropriate starting point. Macroprudential policy is a developing area, and the Committee recognises that there is uncertainty about how its tools will affect credit conditions. It will keep the impact of its use of the instruments under review and it may also conclude that it needs additional direction powers.

Even where it does not have direction powers, the Committee will be able to make recommendations to the PRA and the FCA on a comply or explain basis. During the Committee's interim phase, the FSA has taken several actions in response to FPC recommendations to tackle risks identified by the Committee, as well as supporting other aspects of the interim FPC process. My experience to date is that these tools are appropriate and well understood by the FPC and supporting staff.

In March 2012, the FPC considered recommending that it have direction powers over loan-to-value and loan-to-income ratios, but decided it would not advise that the statutory FPC be given such powers in advance of further analysis, reflection and public debate. I should note that this was before I was appointed to the Interim FPC. Such instruments have advantages and disadvantages. On one hand, there is experience in some countries of using such tools to limit financial instability, and the tool would enable the FPC to act on all regulated UK mortgages, even if the lenders are not prudentially regulated in the UK. On the other hand, it would be difficult for the FPC to determine sustainable levels of property prices, and the Committee noted that the tool would have direct effects on individuals and businesses.

I accept that the loan-to-value/income tools are very powerful and its use by an unelected body would need careful debate. I say this because I am uneasy about the FPC's position being compromised by difficult political-economy considerations. There are in my experience two areas of lending which over time have proved to be difficult in this country, namely high loan-to-value mortgage lending and lending to small firms.

I suspect that the root causes of both are more structural issues, not least that they have more of the characteristics of equity financing than typical loan contracts. I make this point because it is not clear to me that the FPC should seek to use its tools to regulate something (in the case of high LTV lending) which has a more structural element. In other words, the terms of access to high LTV loans is an issue at all times rather than only at times when a countercyclical policy would suggest action. That said, it is still open to the FPC to recommend that steps should be taken to increase the cost of high LTV lending by changing the regulatory capital requirement against such loans.

10. *How powerful will the FPC's powers of recommendation be?*

The Financial Services Act 2012 states, in section 9Q, that "The Financial Policy Committee may make recommendations to the FCA and the PRA about the exercise of their respective functions" and that "if the recommendations are expressed to be recommendations to which this subsection applies, the body to which they are made must as soon as reasonably practicable (a) act in accordance with the recommendations, or (b) if to any extent it does not, notify the Committee of the extent to which it has not acted in accordance with the recommendations and of the reasons for its decision."

As such, the FPC will have a powerful power of recommendation. The PRA will have a PRA Board, constituted of the Governor, Deputy Governors for Prudential Regulation and Financial Stability, the CEO of the Financial Conduct Authority and at least three independent directors. The PRA Board will discuss all recommendations made by the FPC to the PRA, and direct the work that should be carried out to meet the recommendations. The PRA Board will therefore have the role of deciding whether they agree with the recommendations made by the FPC and in what form and over what period of time a recommendation should be implemented.

Prudential Regulation Authority

11. *What are the principal challenges in creating the PRA within the Bank of England?*

I believe there are three main challenges facing the Bank of England and PRA: a numerical increase in the number of staff; cultural differences; and undertaking insurance supervision for the first time.

The creation of the PRA will see the Bank of England grow, in headcount terms, for the first time in the memory of staff there. The number of staff in the Bank will grow by over 50% with the addition of 1070 PRA staff. Since the Chancellor of the Exchequer's announcement of his intention to create the PRA in June 2010, we have been working to ensure that staff can move successfully from the FSA to the PRA. This has involved leasing a building in the City close to the Bank; a major IT project to link the two organisations; as well as a change to supervisory focus. This work will be completed by so-called "Legal Cutover" on 1 April 2013.

Since the supervision of banks moved to the FSA from the Bank of England in 1997, there has been a substantial divergence of culture between the two organisations. The primary reason for this was that the FSA

was made from an amalgamation of numerous different regulators, so developed a very different approach to that of the Bank of England.

Substantial changes have been made in prudential regulation at the FSA since the start of the financial crisis. The FSA began a programme of "intensive and intrusive" prudential supervision. This had some successes in rectifying the pre-crisis failings of not concentrating sufficiently on prudential supervision, but such a process can lead to extremely detailed work.

As a result, I have looked to introduce a supervision approach where prudential supervisors concentrate on the biggest risks to our statutory objectives posed by the firm, rather than pursuing a myriad of issues that in some cases resulted in the FSA being more like an internal audit function than a regulator.

This approach requires rigour in the assessment of risks posed by firms to our objectives. It also requires an ability to be prepared to make judgements, assess their priority and stick by decisions on their importance. I think that we have already seen a strong improvement in the quality of prudential supervision, but we should be under no illusion that there is further to go, and that in our line of activity the constant changes in the world that we supervise means that we have to change ourselves.

There are a number of important areas of the PRA's activity that we recognise remain to be tackled fully. Under the so-called Steady State programme of work which will build on the work of the programme to create the PRA, there will be an overhaul of the approach to seeking and managing data requested by the PRA to further its objectives. Data are obviously important to a supervisory authority such as the PRA. The history and legacy of the FSA indicates the need to improve the approach towards requesting and processing data. The PRA will not overburden firms with unnecessary data requests, and will build systems to allow data to be submitted and used efficiently by supervisors. That said, one important fly in the ointment on this front is the impact of the enhanced European data reporting standards. We have assessed that in some areas these requirements could lead to an increase in data submitted by firms by up to ten times the current amount. Some of these extra data may turn out to be of use to the PRA, but I cannot believe that such a large increase could be justified on the basis of needs.

12. *What will "judgement-led supervision" consist of in practice? Can you give examples from your recent work at the FSA?*

The most high profile case to point to is one I discussed with the Committee in July 2012 regarding the management culture at Barclays. Throughout 2011 and early 2012 there were a number of instances where Barclays were "gaming" the FSA. As the Committee knows, I discussed this with the Board of Barclays, and subsequently Lord Turner wrote to the Chairman of Barclays. This is the type of action that the PRA will, if necessary, take. Moreover, I regularly meet with Boards, and will raise concerns with them.

Another example is capital levels. Basel II introduced the ability for banks to create model-based approaches in order to determine their capital requirements. Some of these models, particularly in the area of commercial property, were, simply not of the right standard. Banks were able to arbitrage the models, and some bad models were approved. In response to the crisis we have taken action in order to apply judgement to rectify the failures in these models by adding what is known as a Pillar 2 capital buffer. To put this into numbers, since 2008, Pillar 1 capital in the major UK banks has increased from £151 billion to £186 billion. Pillar 2 capital buffers, set using supervisory judgement, have increased during the same period from just under £20 billion to £150 billion.

13. *Would the new Prudential Regulation Authority have benefited from a specific secondary competition objective?*

There are in the current form of legislation in our area of policy two approaches to a secondary objective. Parliament has chosen to use the "have regards to" form to set out its intention on competition, which means that when considering its statutory objectives, the PRA must have regards to competition. The alternative is to set out—as for the MPC and FPC—a secondary objective which is subordinated in the sense that it is "subject to" achieving the primary objective(s). Also, the FCA has a primary competition objective. It would not in my view make sense for the PRA to have a primary competition objective, which would confuse the FCA's role, and I would be against this. As to the alternatives, I don't have a strong preference.

14. *What opportunities and challenges do you foresee being created by developments in financial regulation at international level?*

Most policy for prudential supervision is now developed at the international level, and that is entirely sensible given the international nature of major banks. The insurance industry is not as well advanced on this front, but a number of major initiatives are under way.

Typically, policy is created in the Basel/Financial Stability Board arena, but in the EU is then implemented into law via EU legal processes. Some policy comes directly from the EU processes, and this model is more common in insurance (or, at least, it would be if Solvency 2 is finally agreed at some point). The FSB has been a welcome addition to the landscape by acting as a spur to drive on progress in the very necessary but ambitious agenda created by the experiences of the crisis. My best guess is that as we hopefully move into a

more steady state world following the completion of much of this agenda, some rationalisation of the Basel/FSB architecture of policy-making bodies should be possible, but that is something that will probably happen quite naturally.

The European processes are something in which we invest substantial resource and effort, and this is necessary given the impact that they can have on our approach to supervision. Like the Government, I welcome the creation of the Banking Union with its stated aim of giving the European Central Bank the leading role in exercising supervisory authority, particularly over the largest banks in the Banking Union area. I will certainly support the ECB in their work to build the capacity to do this task, because for the PRA it will be important to have the ECB as an effective counterpart. That said, I do not support the UK joining the Banking Union because it is an intended solution to the problems of banks operating in the euro area. Moreover, and to qualify this comment, it would be incorrect and putting too much pressure on the Banking Union to think that on its own it can solve the problems of the euro area, but if done well it can certainly help.

But the EU processes also create difficulties for the PRA, and this could be an area of future tension. The PRA approach is quite clearly one which uses supervisory judgement against a framework of rules. In the EU processes I see a pressure to create more binding rules at an ever more detailed level, and to use the so-called maximum harmonisation approach which in effect means that the rules set both the minimum and maximum standards to be applied. Failures of past supervisory judgement have led to a pressure for more rules in the European Union, as has the pressure to preserve the Single Market. I strongly support the free trade underpinning of the Single Market, but I do not see ever more detailed rule-making as a sustainable solution to the identified problems, and nor is it necessary to achieve the free trade objectives of the Single Market. Supervisory judgement in the application of rules has to be exercised within an institutional structure that has authority. The PRA will benefit from the authority of the Bank of England in this respect, just as I hope the ECB will exercise similar authority in the Banking Union. But there has to be scope for these authorities to exercise judgement because they are dealing with risks that may appear in the future. This distinction between a forward and backward-looking approach lies at the heart of the difference between applying judgement and ticking boxes.

15. *Can you envisage there being conflicts between macroprudential and microprudential policy? If so, how should they be resolved?*

First of all, I do not see the scope for inherent tension between macroprudential and microprudential supervision because the objectives of each have been well defined in statute. For instance, the FPC must take responsibility for risks at the level of the financial system, but it must not recommend policies on the safety and soundness of individual institutions. This is all well understood in my view.

The second protection in this area is transparency and accountability. Neither of these worked well in the post-1997 structure of financial regulation and supervision, and that is part of the cause of failure in the system. To take the role of the PRA as an example, if the Board of the PRA does not accept the full terms of a recommendation made to it by the FPC, it must explain why it is deciding not to comply with that recommendation. This will be transparent, and will no doubt be subject to review by the oversight process of the Court of the Bank of England, and also the Treasury Select Committee.

As to whether there will be conflicts, the scope for such an outcome will be reduced by the clarity with which both bodies set out their approaches to their tasks. I believe that the work done to date, and published, on the FPC's Tools and the PRA's Approach to Supervision gives grounds for optimism on this front.

16. *Can you envisage conflicts between the work of the PRA and that of the Financial Conduct Authority? Can you envisage using the PRA's power of veto over FCA decisions?*

There is a natural difference of interest between prudential and conduct supervision which flows from their different objectives in statute. The identification of these different interests lies at the heart of the so-called Twin Peaks approach that the reforms are about to introduce. My own experience of working in the senior management of the FSA for the last two years has helped me to understand better the issues that can arise. I think that over its life the FSA has found it very difficult to achieve a stable balance between prudential and conduct priorities. This is not surprising, or intended as a criticism, because under integrated supervision the FSA has had to balance many competing priorities from around 25,000 authorised firms. Since the introduction of so-called Internal Twin Peaks in the FSA nearly a year ago, I have observed the benefits of the separation leading to a clearer articulation of both prudential and conduct cases in areas where the two naturally come together and can (again, naturally) lead to different preferences for outcomes.

The question raises the possibility of the PRA using its power of veto over FCA decisions where differences of preference become acute. First of all, it is important to bear in mind that

the statute rightly sets a rigorous framework around the use of the veto which is tightly linked to the PRA's objective in terms of the safety and soundness of firms in the context of the stability of the financial system (the PRA's General Objective). I would note here that the veto cannot be used in the context of the PRA's insurance objective to protect policyholders, which I do not envisage at this time as a problem. As a general matter I start from the presumption that powers are put into statute to be used, so we must contemplate use of the veto (and I say that not with any intention to be trigger happy). But I can see a situation (and this is an

entirely hypothetical scenario) where a major issue for the FCA which requires substantial redress and cost to a PRA supervised firm or firms could be of such scale that the PRA uses the veto to achieve a different outcome (for instance, a more elongated redress period). Also, I think that it is important not to regard such an outcome as a failure of the system of supervision. On the contrary, I can see circumstances in which it would be in the interests of both the FCA and the PRA for the veto to be used where appropriate so that there is clear transparency and accountability in the decision-making. This strikes me as better than opaque back-room compromises.

17. *How will you coordinate the work of PRA staff and that of the Bank of England staff working on financial stability?*

Over the last six months or so, as the creation of the PRA has become more of a reality, and particularly now that we have moved into our new home in Moorgate near to the Bank's main building. I have been keen to encourage greater co-ordination of working across many parts of the Bank. A senior member of the Bank staff has taken responsibility for a programme of work to build contact and greater understanding of the work of each part of the Bank and PRA-to-be. It is of course a reflection of the weaknesses of the previous system that this type of engagement was not more commonplace. Contact is increasing, and we have launched specific initiatives, for instance with Bank staff taking a larger role in the creation of scenarios for PRA stress testing, PRA staff providing insights for Bank staff on the impact of sustained low interest rates on insurers, the extensive work on market intelligence and substantial work around resolution planning. In my view, as the two groups of staff come together, our task is to let these initiatives take root and encourage further co-ordination.

18. *Is the UK banking system too concentrated?*

There is no doubt that the UK banking system is more concentrated than it was before the crisis, when the demutualised building societies were still present, and a larger number of foreign banks were active. This was certainly true of retail banking models. The crisis revealed many of these businesses to be unsustainable and to be deeply flawed in their business models. It follows that greater competition in the future must be based on robust and sustainable institutions that meet the PRA's safety and soundness objectives. I firmly believe that we cannot compromise on our objectives of safety and soundness because to do so will create unsustainable competition and trouble ahead.

In sum, I want to see a more diverse banking system, but not at any cost. To that end, we will be publishing changes to the prudential authorisation requirements in order to lower barriers to entry for new banks. The broad outline of these changes was described by Adair Turner in his recent evidence to the Parliamentary Commission on Banking Standards. I believe that these changes will mark an important step forward in promoting the entry of new banks in the UK market. There is a very important principle underpinning the changes that we will make on the prudential side, namely that where a bank can demonstrate to our satisfaction that it could be subject to resolution without unacceptable uncertainty about the threat to an orderly process of resolution, then we should lower the discretionary capital requirements to which it is subject (in the Basel language, this is the Pillar 2 requirement). I think that this means, given the current state of confidence around resolution outcomes, that banks must demonstrate that they can be resolved using the Bank Insolvency Procedure, based on the rapid pay-out of insured deposits. This is a cautious standard, requiring banks to demonstrate that they have implemented successfully the so-called Single Customer View (SCV) to enable depositor pay-out rapidly. This should not pose an unreasonable burden for new banks since the best time to establish the capability for SCV in a bank's systems is at "day one".

The logic of this argument on new banks is that we should implement a similar arrangement for all small banks and building societies. This approach is consistent with the principle of proportionality set out in our approach to the supervision of banks. My strong view is that the PRA must put into practice its commitment to proportionality in its approach to supervision and thus seek to encourage a reduction in concentration in the UK banking system and the availability of greater choice to consumers.

19. *What risks are posed by the shadow banking system?*

I define shadow banking as institutions performing activities that pose risks similar to those of banks but which are outside the system of prudential regulation (whether that is carried out by the PRA or FCA). I tend to focus on two main risks:

— that these institutions can adopt bank like behaviour when raising funds and thus engage in forms of maturity transformation (constant net asset value money market funds are an example of this risk). My view on this risk is that institutions undertaking maturity transformation require an appropriate degree of regulation through the risk that they will transmit disorderly conditions to other institutions and financial markets through a loss of confidence originating in the providers of funding. It is worth noting here that such funding has in the past been considered in a narrower context of deposit funding. It is unwise to adopt such a limited definition, and the crisis has demonstrated the presence of this maturity transformation risk through secured funding and through maturity mismatches in the terms by which institutions gain access to the financial instruments used to secure such funding (collateral term mismatches); and

— the second risk from institutions that should be considered as shadow banks arises, in my view, where they are highly interconnected to other parts of the financial system, and particularly those parts (like banks) that are considered to be likely to spread risk across the system. Interconnectivity is not easy to measure and assess, but a good test for me is how easy it would be to resolve a shadow banking institution in the event of failure without causing wider concerns for the stability of the financial system. As an example, the crisis has demonstrated that even in periods of very heightened fragility the experience suggested that hedge funds can leave the scene without causing difficult disruption. But, I do not think that today we are sufficiently confident that this outcome would hold for the very largest funds. This requires a more rigorous approach to answering the "what if" type questions, but I would stress that in my view this question applies to a fairly small number of institutions.

20. *What are your objectives for the regulation of the insurance industry? How do you intend to fulfil your mandate to protect policyholders?*

I refer the Committee here to my recent Barbon Lecture which is included in the set of relevant speeches indicated in my answer to Question 3. My objective for the regulation of insurers is consistent with that for banks, namely to ensure continuity in the supply of critical financial services, here risk transfer and long-term savings. In the Barbon Lecture, I set out my thinking on why the PRA needs to have a policyholder protection objective (in other words, what distinguishes a policyholder from a bank depositor). A particular aspect of this issue that I highlighted in the lecture was the very long-term nature of some insurance contracts, and the ways in which those contracts tie in policyholders.

In the Barbon Lecture I sought to set out three important areas where in my view supervisory issues exist. The first area is in the life insurance field and concerns long-term savings contracts. There is a trade-off in this area between the risks (prudential and conduct) created by quite imprecise contracts (characteristic of with profits contracts) and risks created by writing such contracts with harder guarantees (where the prudential risks can be sharper). Variable annuities can have some of the latter characteristics. In my view, the issues arising from these types of contract will be important for our supervision of insurers. I should add that these risks also need to be viewed in the context of sustained very low interest rates.

The second area that I highlighted in the lecture concerns the resolution of insurers that cease to write new contracts (here, I deliberately avoid using the word "failure" because this does not account for all the reasons that insurers enter run-off). It is worth bearing in mind that today the FSA supervises over a hundred insurers in run-off. For general insurance, the objective here should be to ensure continuity of cover for the risks insured. The duration of the run-off period will typically be shorter for general than life insurance, and thus the issues are usually less complex. For life insurers, run-off can happen over many years in view of the term of contracts. Complex issues arise around term subordination (how to be even-handed towards near-term and far-term claims on the pool of assets), and the inter-generational transfer created by having very large and long-lived asset pools.

The third issue that I highlighted is work underway at present, led by the International Association of Insurance Supervisors, under the auspices of the FSB, to determine a status of systemically important insurance firms. In the lecture, I made the point that while it is important to understand the nature and particular risks of these firms, we should be careful not to apply a one-size-fits-all solution based on the bank model, in terms of the diagnosis and solutions. Put simply, the systemic importance of insurers needs to be determined rather than assumed.

Accountability and Governance

21. *What is your view of the Treasury Committee's Reports on the Accountability of the Bank of England (21st and 27th Reports of Session 2010–12), and on the Financial Services Bill so far as it relates to the Bank of England (1st Report of Session 2012–13)?*

Accountability is crucial to the success of the Bank of England in its new roles. The 1997 reforms were a success in this respect in terms of the arrangements for the MPC. But the same was not true for financial stability and financial regulation. The new legislation has set out clear objectives for the FPC and PRA, and I welcome the Treasury Committee's commitment to expanding its role in accountability. There is no doubt that public policy is likely to be done better when there is effective accountability for policymakers.

That said, as the TSC reports make clear, there is an important role for the Court of the Bank of England in providing oversight of the actions of the Bank. Formally, the legislation does not provide the oversight of the PRA by the Oversight Committee of the Bank's Court, but the Court has decided that it will take on this role in practice. I support this decision. It means that the Court will exercise oversight over the PRA Board of Directors.

The Treasury Committee has rightly indicated that the Court needs to be an effective and transparent governing body responsible for both the overall management of the Bank and for ensuring that the policymaking responsibilities are discharged effectively. I welcome the role of the Oversight Committee in retrospective review of policymaking, and the commitment to ensure that this role is distinct from that of the actual policymakers who are individually accountable for their judgements.

22. *How can the FPC and PRA be properly accountable to Parliament while maintaining necessary confidentiality?*

I agree with the recommendation made by the Treasury Committee in its report on accountability of the Bank of England, namely that the Bank/PRA "will need to explain its decisions more fully to Parliament than has been the case with some regulators, for example the Financial Services Authority".

Of course, confidentiality of information is an issue, as is the risk that explicit public comments by regulation can contribute to a loss of confidence among the public. That said, the financial crisis has provided a stark reminder of the public interest in the performance of banks and their regulators. I hope that a lasting solution will be found to the public money/too big to fail issue, but that is not the limit of the public's interest in banks, given their crucial role in providing critical services, including credit creation. This means I think, that in spite of confidentiality concerns, there will need to be much greater transparency than in the past. All participants will need to live with this and accept that the world will not be the same again. That said, there are of course limits to transparency where commercial confidence is at issue, and indeed there are other legal requirements that limit open disclosure. I would therefore suggest that the Committee considers how it could take evidence in confidence.

23. *What role should the Court of the Bank of England perform? How can it be made more effective?*

In my answer to Question 21 I emphasised that Court will have a very important role in providing oversight of the policy actions of the Bank. This role sits alongside the responsibilities of the Court in respect of the strategy, management and budget of the Bank. Although I have not been a member of the Court until now, I have attended meetings over a long period of time, and this has provided a good insight into its workings. My overall conclusion is that where the Court has been asked to undertake a role of oversight, it has done so effectively and with energy. In saying this, I should note that today's Court is very different to the Court of ten or twenty years ago. As an example, the Bank now has a functioning Audit Committee, which was not a feature twenty years ago. A good example of the outcome of Court's oversight is the strong budget discipline that I believe has been exercised by the Bank.

The said, it is imperative that Court can in future ensure that the Bank's policy committees (MPC, FPC and the PRA Board) are performing competently and executing their responsibilities appropriately. Mark Carney set out the following roles for Court in this area in his submission to this Committee:

— observing, and reporting on the effectiveness of, the way policy is made;

— giving assurance that the policy process is as transparent as possible and that information is not withheld without very good reason, from Parliament or public;

— commissioning reviews, by independent experts and by policy-makers, of past policy settings; and

— overseeing the response of policy committees to the lessons in any such review.

I agree strongly with this assessment of the oversight role of the Court to be exercised by the new Oversight Committee. The Court will have my full support in establishing and performing these functions.

24. *What is your view of the structure and inter-relationship of the Bank's committees? Could these be made more effective without loss of transparency?*

Modern central banks, like the Bank of England, have developed highly stylised forms of committee decision-making which place a strong emphasis on deliberation and reason-giving for decisions as much as the decisions themselves. In other words, explaining and justifying decisions is an important part of good public policymaking, and in doing so individual policymakers should be willing to learn from one another. I certainly subscribe to this view, and that members of each committee should be able to learn from the views of members of the other committees on their respective areas of policy responsibility. Good policymaking is therefore more than a process of aggregating the preferences of individual policymakers found in isolation.

In future the Bank will have three policy-making bodies, the MPC, FPC and the PRA Board. They will be different as a consequence of their different objectives and tools. The MPC uses one policy tool at a time, and while the thinking around policymaking is highly sophisticated, the outcome is focused on a single setting of a tool. The FPC has multiple tools in terms of its potential policy actions, and it can (and typically will) be using several tools at any moment in time. This is well understood as a consequence of the nature of financial stability, but challenging in terms of the clarity of explanation. The PRA Board has to deal with many decisions at any given point in time, and the fact that its objective and tasks directly impinge on concentrated private interests (those of the firms it regulates). It has a similar basis for its public policy objectives, but a very different operating environment in terms of the nature of its decisions. This difference was in the past a reason for the separation of microprudential supervision from the Bank of England, based on the conclusion that it was a very different task which had more in common with other areas of financial regulation. This was in my view a mistake, and the commodity of interest between microprudential supervision and macroprudential and monetary policy outweighs the differences.

Until the FPC and the PRA Board are properly up and running it is too early to say how they could be made more effective. That said, my clear preference is that there is transparency between the committees of the Bank and opportunities are found for members to discuss issues of common interest. This is already starting to take place, but to be clear I do not believe that this should compromise the separate formal decision making processes, and thus I do not see an advantage in joint policymaking meetings and the like.

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